Middleburg
Financial Corporation

October 15, 2012

Via e-mail: regs.comments@federalreserve.gov.

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, DC 20551.

Re: Basel III Regulatory Capital Ratios Proposal and Risk-Weighted Assets Proposal; Docket No. R–1430, RIN No. 7100–AD87; and Docket No. R–1442, RIN No. 7100-AD87.

Dear Ms. Johnson:

Thank you for giving us the opportunity to comment on the Basel III Regulatory Capital Ratios Proposal and Risk-Weighted Assets Proposal (collectively referred to as the "Basel III Proposals"). Middleburg Bank is the banking subsidiary of Middleburg Financial Corporation, a bank holding company. We are a community bank with $1.2 billion in assets and 11 branches, all in the Commonwealth of Virginia.

The Basel III Proposals cause us a great deal of concern. We would like to take this opportunity to highlight specific proposals that will be harmful to our institution.

The Basel III Proposals include unrealized gains and losses in Available-For-Sale securities in Tier 1 Capital. Like most banks, Middleburg Bank has seen its investment portfolio grow amid strong deposit growth coupled with tepid loan demand which has forced us to deploy excess liquidity into lower yielding investments. The majority of our investment portfolio is securities that are either full faith and credit of the US government or securities issued by Fannie Mae and Freddie Mac. The primary purpose of the investment portfolio is to provide liquidity. We recognize that the investment portfolio has interest rate risk as do most other earning assets on the balance sheet. That is why we manage the interest rate risk of the institution very carefully. We recognize that higher interest rates will lead to unrealized losses on our securities; however, our time deposits will probably be worth more in a higher interest rate environment. So while the aggregate interest rate exposure of the institution may not have changed, because deposits are carried on the balance sheet at cost rather than at market value, unrealized losses on the available-for-sale securities portfolio will grossly overstate the interest rate risk exposure of a bank such as ours that has a preponderance of time deposits, most of which are funds provided by our core retail customer base. Therefore, if the ostensible reason for including unrealized gains and losses on securities in Tier 1 capital is to address interest rate risk in the securities portfolio, the proposal is one-sided since it does not give banks credit for their time deposits and asset-liability management. Higher interest rates will lead to unrealized losses in the securities portfolio which will result in reduction of capital if the proposal is adopted without any modifications. The banking agencies have issued comprehensive guidance on interest rate risk. If the regulators receive assurance that institutions are managing interest rate risk within a prescribed tolerance, banks should not have to set aside additional capital for interest risk.

Another proposal that is troublesome to us would potentially increase risk weights for residential mortgage loans. The proposal requires that all mortgage loans be classified into Tier I or Tier II, with different risk weights in each tier depending on the Loan-to-Value ratio. Aside from the fact that the LTV criteria are arbitrary and an imperfect measure of risk, the operational burden of reconfiguring our systems to accommodate the tiering will be quite costly for us. The higher risk weightings for Type II mortgages will also result in banks such as ours electing not to make balloon loans to credit-worthy borrowers We would recommend that, instead of the proposed Tier I and Tier II with the LTV breakpoints, all Qualified Mortgages be given a 50% Risk Weight and others be risk weighted at 100%.

Another aspect of the Basel Proposals would require that banks risk weight all off balance sheet guarantees (including reps & warranties) using a Credit Conversion Factor (CCF) of 100%. We maintain buyback reserves as do most banks. Rather than forcing the credit enhancing reps & warranties on to the balance sheet and requiring the use of a 100% CCF, both of which would balloon risk-weighted assets and push down the capital ratios, we think that a better approach would be to require that banks have adequate buyback reserves and liquidity in the event that loans must be repurchased. The proposed approach if implemented will have the unintended effect of causing community banks like us to severely curtail their ability to offer mortgages to their customers.

The Basel Proposals call for the phasing out of Trust Preferred debt for all banks. Middleburg Financial Corporation has some Trust Preferred debt on its books. Like most Trust Preferred debt, the rate is floating. Being prudent risk managers, we entered into a swap whereby we swapped the floating rate to a fixed rate. At the time, we were assured by the Collins Amendment which provided an exclusion for banks with assets below $15 billion. If we are required to phase out the debt, we would lose hedge effectiveness and would have to terminate the swap which in turn would cause us to recognize a large loss. We think that the Collins exclusion for banks that have assets below $15 billion should be honored. We would have a difficult time replacing the capital – not to mention the significant losses that we would incur on swap termination, which would further reduce capital.

In closing, we think that the conceptual idea of Basel is a good one; however, many of the prescriptions should not be forced onto community banks. They have a simpler business model than do their larger brethren, and have less access to capital than do the larger institutions. Smaller banks also have fewer resources than do larger banks, precisely because we are not engaged in the wide array of complex activities that characterize the bigger banks.

The reduced capital would mean that we may not be able to make certain types of loans or, indeed, as many loans to our community as we would have under a more well thought out capital regime. We have tried to offer suggestions for some of the proposals that could be most damaging to our bank and its customers. We hope you will take these suggestions under consideration and proceed with caution. You might also consider conducting outreach to community banks as a means to field-test the proposals.

Thank you for your consideration of our comments.

Sincerely,

Gary R. Shook
President & Chief Executive Officer

Raj Mehra
Executive Vice President
& Chief Financial Officer

Jeffrey H. Culver
Executive Vice President
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